

Tax Incentives for Using Alternative Dispute Resolution Methods

I. INTRODUCTION

It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity, but to their self-love, and never talk to them of our own necessities but of their own advantages.¹

—Adam Smith

A. The Problem — The Litigation Explosion

In our litigious society, “[t]he courts have become the final repositories of social trust, and they have sought to discharge their duty by holding accountable those whose trust was not merited.”² The volume³ and complexity of litigation, however, threaten to render our court system ineffective as the primary dispute resolution mechanism to effectuate social trust. Although 95 to 99 percent of civil cases are settled before juries reach their verdicts,⁴ a massive backlog in the court docket still exists.⁵ The overwhelming caseload threatens the quality of the decisions rendered.⁶

1. A. SMITH, *THE WEALTH OF NATIONS* 14 (E. Cannan ed. 1937).

2. J. LIEBERMAN, *THE LITIGIOUS SOCIETY* 186 (1981). Lieberman's explanation of this statement is that “[l]itigiousness is not a legal but a social phenomenon. It is born of a breakdown in community, a breakdown that exacerbates and is exacerbated by the growth of law. A society that is law saturated inclines toward the belief that in the absence of law anything goes. No restraints of common prudence, instinctive morality, or reflected ethics need deter or function. What is not declared unlawful is perforce permissible.” *Id.*

3. Studies have indicated that case filings increase when the economy improves and when judges are added to trial courts. Marvell, *Civil Caseloads: The Impact of the Economy and Trial Judgeship Increases*, 69 *JUDICATURE* 153 (1985). “[A] 10 per cent rise in a state's economy over each of the prior three years would mean roughly 12 or 13 per cent more trial filings in the current year.” *Id.* “A 10 per cent increase in trial court judges leads to roughly two per cent more civil trial filings and four per cent more appeals.” *Id.*

4. J. O'CONNELL, *THE LAWSUIT LOTTERY* 84 (1979).

5. The magnitude of the backlog can be shown by some startling statistics. From 1970 to 1982, the annual number of civil suits filed in federal court doubled to more than 200,000. Thomas, *How to Stay Out of Court*, *MONEY*, May, 1983, at 177-78. From June 30, 1980, to June 30, 1985, the number of cases filed annually in federal district courts alone increased 58.7 percent from 188,487 to 299,164. *FEDERAL COURTS: DETERMINING THE NEED FOR ADDITIONAL JUDGES*, GAO/GGD-87-26BR, (Jan. 1987). Due to the increase in cases filed, among other factors, Congress authorized 63 new federal district court judgeships based upon the 1982 District Courts Biennial Survey. *Id.* at 11. Congress had not yet acted upon the 1984 survey recommendation of 66 new judgeships as of December 1, 1986. *Id.*

6. Justice Antonin Scalia, in speech before the ABA. *N.Y. Times*, Feb. 16, 1987, § 1, at 1, col. 1.

Litigation is expensive as well as time-consuming. The long period of discovery between filing and trial consumes clients' financial resources. As New York attorney Arthur Liman said, "Discovery has become a narcotic for members of our profession."⁷ Finally, augmenting the number of court personnel in order to deal with increased court filings⁸ absorbs a large portion of the public purse.⁹

Due to these problems with court-based litigation, courts, public agencies, and legislatures have devised, or permitted the use of, various alternative dispute resolution methods as substitutes or potential substitutes for actual court-based litigation.¹⁰ Despite the general availability and advantages of these devices, alternative dispute resolution mechanisms are still not widely used.¹¹

This Note will focus on tax incentives as a means of encouraging use of alternative dispute resolution (ADR) methods and tax disincentives as a means of discouraging use or protraction of litigation. A fundamental principle is that human behavior is greatly influenced by the economics of advantage to one's self;¹² consequently, "the mixture of incentives that currently brings people to court can be changed and barriers to litigation can be installed in their place."¹³ This Note will first examine the theory and use of tax incentives to effectuate public policy; second, examine the economics of the use of litigation and ADR methods; and third, recommend possible changes in Internal Revenue Code provisions which could encourage use of ADR methods by business and individuals.

B. A Potential Solution — Alternative Dispute Resolution Methods

Although it is not the purpose of this Note to discuss the benefits or detriments of ADR methods,¹⁴ a brief introduction to the different types of ADR methods is in order.

7. Liman, *The Quantum of Discovery vs. The Quality of Justice: More is Less*, 4 LITIGATION 9 (1977).

8. Marvell indicates that increasing judgeships is partly self-defeating, since more cases are filed in response to the perception that additional judges reduce delay in the courts. Marvell, *supra* note 3, at 153, 155.

9. This fact may be inferred from the massive increase in filings of new cases. See *supra* note 5.

10. From 1971 to 1983, forty states established neighborhood justice centers, most of which are state funded. Thomas, *supra* note 5, at 177, 180. From 1982 to 1984, "[l]egislators in some seventeen states [had] enacted at least nineteen laws relating to mediation," including appropriations for state funding of mediation, authorization of neighborhood dispute resolution centers, and comprehensive laws about community mediation, family and divorce mediation, and small claims and mobile home park mediation. Freedman, *Legislation on Dispute Resolution*, 1984 A.B.A. SPECIAL COMM. ON DISPUTE RESOLUTION. Private enterprise has devised the rent-a-judge concept in which a retired judge can be hired for \$150 an hour to help resolve disputes. Thomas, *supra* note 5, at 178.

11. Hesitancy to use novel forms is not unexpected: See *infra* text accompanying notes 117-19. The use of alternative forms is increasing, however. For example, over a ten year

Alternative dispute resolution methods can involve the use of attorneys or other persons as third-party mediators of various types of disputes. Examples include mediation between spouses or family members,¹⁵ neighbors,¹⁶ and small claims contestants.¹⁷ Attorneys also participate in arbitration proceedings,¹⁸ various types of negotiations,¹⁹ and claim settlements in areas such as personal injury²⁰ and debt collection.²¹ The proposals made herein are meant to apply to these and other alternative dispute resolution methods which substitute for court-based litigation.

II. THE ECONOMICS OF TAX PROVISIONS

A. General Economic Theory and the Effect of Taxation Upon Economic Decision-Making

The market system assumes persons are rational in their economic choices.²² It assumes that through "selfish" decision-making, economic actors will engage in "utility maximization," that is, decision-making

period, the number of arbitrations heard by the American Arbitration Association doubled to 38,000 annually by 1982. Thomas, *supra* note 5, at 178.

12. R. POSNER, *ECONOMIC ANALYSIS OF LAW* 3-4 (3d ed. 1986); D. McCLOSKEY, *THE APPLIED THEORY OF PRICE* 1-2 (1982).

13. J. LIEBERMAN, *supra* note 2, at 172.

14. Scholarly treatment of these issues may be found in this and other such law journals.

15. ALASKA STAT. § 25.20.080 (1983); CAL. CIV. CODE § 4607 (West 1983 & Supp. 1987); FLA. STAT. ANN. § 61.052 (West 1985 & Supp. 1987); MICH. COMP. LAWS ANN. § 552.501 (West Supp. 1987); OR. REV. STAT. § 107.755 (1984).

16. CAL. CIV. PROC. CODE § 1143.10 (1980) (repealed 1982); COLO. REV. STAT. § 13-22-301 -22-310 (Supp. 1986); COLO. REV. STAT. § 38-12-216 (1982).

17. Arkansas, Kentucky, and Massachusetts have statutes relating to mediation of small claims. *Noted in* Freedman, *supra* note 10, at 1.

18. An insurance company may require, as a term of the contract, for instance, that an uninsured or under-insured motorist claim by a policyholder be submitted to arbitration. The arbitration panel may be one in which the insurance company and the policyholder's attorney each select one attorney to act as arbitrator and, then, those two attorneys select a third attorney to act as chair of the panel. Counsel for the policyholder-plaintiff and insurance company-defendant present their cases to the panel, as they would in court, and the arbitration panel renders a decision as to the amount of damages to be rendered.

19. The attorneys of two companies involved in a contract dispute will, for example, attempt to negotiate a compromise before resorting to the courts or to another ADR method.

20. The plaintiff's personal injury lawyer will attempt to negotiate a reasonable settlement with the insurance company's adjuster; if such negotiations prove unfruitful or if the statute of limitations draws near, suit would be filed, although settlement could occur subsequently.

21. Businesses of various kinds often hire attorneys to collect debts owed them. If the initial demand for payment goes unanswered or answered unsatisfactorily, the business may resort to the legal system.

22. A. SCHOTTER, *FREE MARKET ECONOMICS* 2-3 (1985); R. POSNER, *supra* note 12, at 3.

which results in their greatest satisfaction.²³ Utility maximization is achieved when an activity is pursued until the marginal benefit of the activity is equal to the marginal cost of pursuing it further.²⁴ Thus, when an activity costs more to pursue than the expected benefits to be derived, a person will cease further pursuit of that activity.²⁵

The utility maximization concept is applicable to litigants' decisions either to settle a case or to await the jury's verdict. The plaintiff weighs the cost of prosecuting its suit, the potential benefit to be derived, and the likelihood it will win.²⁶ On the other hand, the defendant weighs the cost of defending the potential exposure to damages, and the likelihood of a defense verdict or the reduction of damages to be realized by conducting a vigorous defense.²⁷ This cost-benefit decision-making by both sides may be illustrated as follows:

In a civil case, let the expected judgment be \$100,000 and assume that both parties agree on its size; let the probability that the plaintiff will be awarded the judgment be .50; let the defendant's trial cost be \$10,000; and let the plaintiff's trial cost be \$20,000. If this is the case, the plaintiff's expected net gain from going to trial is \$20,000 and the defendant's expected costs are \$50,000. Since the plaintiff's expected net gain is \$20,000 and the defendant's expected net cost is \$50,000 then there is a \$30,000 range within which settlement can occur. That is, the plaintiff will settle for some amount over \$20,000 while the defendant will settle for some amount less than \$50,000.²⁸

Thus, where cost-benefit analysis reveals a range of potential verdicts, each side may be willing to settle within a certain range.

Likewise, the law affects economic choices persons make concerning the method of dispute resolution. Economist John MacDonald Oliver noted that one purpose of laws is to maneuver people into behavior patterns different from those they would follow in the absence of such laws.²⁹ Whether or not the law has the explicit purpose of encouraging or discouraging a specific course of action, economics provide an explanation for the result.³⁰ The economic explanation is particularly strong with respect to tax provisions. The general principle is that "[t]he imposition of a tax on an activity creates an incentive for people engaged

23. *Id.* at 2; Zinam, *The Roles of Equilibrium, Optimality, Maximization, and Discount in Decision-Making Processes*, 38 AM. J. ECON. & SOC. 163 (1979).

24. D. MCCLOSKEY, *supra* note 12, at 43.

25. N. MERCURO & T. RYAN, *LAW, ECONOMICS, AND PUBLIC POLICY* 119-20 (1984).

26. *Id.*; Landes, *An Economic Analysis of the Courts*, 14 J. L. & ECON. 61, 101-07 (1971).

27. N. MERCURO & T. RYAN, *supra* note 25, at 119-20; Landes, *supra* note 26, at 61, 101-07.

28. N. MERCURO & T. RYAN, *supra* note 25, at 119-20.

29. J. OLIVER, *LAW AND ECONOMICS* 13 (1979).

30. *Id.*

in the activity to substitute another activity that is taxed less heavily.”³¹

The federal income tax system consists of two parts: (1) a basic system of structural provisions which mechanically imposes taxes in order to derive public funds without regard to special governmental policies, and (2) a system of tax expenditures.³² By use of these two parts, the tax system attempts to accomplish three primary goals: (1) to transfer resources from the private to the public sector; (2) to distribute the cost of government fairly by income classes and among people in approximately the same economic circumstances; and (3) to promote economic growth, stability, and efficiency.³³ In addition to these broad policy goals, specific social and economic goals have been aided through tax expenditure provisions.

B. History and Effect of Tax Incentives

Congress uses tax expenditures to promote various social and policy objectives considered desirable.³⁴ Tax expenditures are either in the form of deductions or credits. Deductions reduce the amount of income subject to the taxpayer's marginal rate, making tax savings equal to the amount of the deduction times the taxpayer's marginal rate.³⁵ Credits, on the

31. R. POSNER, *ECONOMIC ANALYSIS OF LAW* 364 (2d ed. 1977).

32. Tax expenditures are defined as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provides a special credit, a preferential rate of tax, or a deferral of tax liability....” Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 706 (1970). See generally S. SURREY & P. MCDANIEL, *TAX EXPENDITURES* 3 (1985).

33. J. PECHMAN, *FEDERAL TAX POLICY* 5 (4th ed. 1983).

34. A number of scholars, however, criticize the utility of credits and deductions for achieving congressional purposes; they argue instead for cash payments. R. P. Hoff, for example, states that “[a] tax credit is a relatively weak incentive for taxpayers in the upper income levels and an ineffective equity instrument for taxpayers who have little or no positive tax liability.” In addition, she argues that “[g]iving a credit for a business expense (e.g., investment expense) separates the concept of income from any notion off gain; giving a credit for a personal expense (e.g., child and dependent care expense) separates the concept of income from the notion of ability to pay. Allowing a tax credit for nonbusiness expenses which otherwise would be allowable only as an itemized deduction (e.g., for political contributions) circumvents the zero bracket amount. In short, the use of tax credits to achieve tax equity and nontax incentive goals complicates the tax computation process without attendant advantage.” Hoff, *The Appropriate Role for Tax Credits in an Income Tax System*, 35 TAX LAWYER 339, 343, 351. See also generally, Gottschalk, *Deductions Versus Credits Revisited*, 29 NATL TAX J. 221 (1976); Sunley, *The Choice Between Deductions and Credits*, 30 NATL TAX J. 243 (1977). Surrey concludes that subsidies or direct governmental expenditures would be more efficient in accomplishing governmental objectives. Surrey, *supra* note 32, at 706. He also criticizes tax expenditures as being of more value to higher income taxpayers; however, in light of the change to fewer tax brackets for individual income taxes under the Tax Reform Act of 1986, this inequity is greatly reduced.

35. Sunley, *supra* note 34, at 243.

other hand, directly reduce the amount of tax liability.³⁶ Whether a credit or deduction is chosen to effectuate a particular tax expenditure may be of little consequence because it is possible to calculate the amount of a credit which would be the equivalent of a deduction such that the end result (decrease in tax liability) would be the same regardless of which method is used, assuming the same marginal rate.³⁷

Since 1962, Congress has enacted numerous credits and deductions to promote a host of special non-tax purposes:³⁸ employment and job creation;³⁹ aid to certain persons or causes deemed worthy of special treatment;⁴⁰ development of energy sources and conservation of energy;⁴¹ home ownership and low-income housing;⁴² research and development;⁴³ business development, expansion, and modernization;⁴⁴ purchase of consumer and other goods;⁴⁵ improvement of environmental quality;⁴⁶ pur-

36. *Id.*

37. Gottschalk, *supra* note 34, at 225 (1976).

38. Certain deductions and credits existed prior to 1962; deductions have existed since at least 1913 and credits since 1924. The greatly heightened use of tax expenditures to promote particular policies, however, is considered to have begun in 1962. Hoff, *supra* note 34, at 348-49, 361.

39. *E.g.*, I.R.C. § 21 (1987) (expenses for household and dependent care services necessary for gainful employment); I.R.C. § 51-52 (1987) (targeted jobs credit); I.R.C. § 176 (1987) (payments with respect to employees of certain foreign corporations); I.R.C. § 217 (1987) (moving expenses).

40. *E.g.*, I.R.C. § 22 (1987) (credit for the elderly and the permanently and totally disabled); I.R.C. § 188 (1987) (earned income credit); I.R.C. § 170 (1987) (charitable contributions and gifts); I.R.C. § 188 (1987) (amortization of certain expenditures for child care facilities); I.R.C. § 190 (1987) (expenditures to remove architectural and transportation barriers to the handicapped and elderly); I.R.C. § 192 (1987) (contributions to black lung benefit trust); I.R.C. § 215 (1987) (alimony payments).

41. *E.g.*, I.R.C. § 23 (1987) (residential energy credit); I.R.C. § 34 (1987) (certain uses of gasoline and special fuels); I.R.C. § 40 (1987) (alcohol used as fuel); I.R.C. § 193 (1987) (relating to tertiary injectants).

42. *E.g.*, I.R.C. § 25 (1987) (interest on certain home mortgages); I.R.C. § 42 (1987) (low income housing credit); I.R.C. § 216 (1987) (deduction of taxes, interest, and business depreciation by cooperative housing tenant-stockholder).

43. *E.g.*, I.R.C. § 28 (1987) (clinical testing expenses for certain drugs for rare diseases or conditions); I.R.C. § 41 (1987) (credit for increasing research and development); I.R.C. § 174 (1987) (research and experimental expenditures).

44. *E.g.*, I.R.C. §§ 38-39, §§ 46-49 (1987) (general business credits relating to depreciable property); I.R.C. § 162 (1987) (trade or business expenses); I.R.C. §§ 167-168, 179 (1987) (depreciation of assets); I.R.C. § 172 (1987) (net operating loss deduction); I.R.C. § 173 (1987) (circulation expenses for newspapers, etc.); I.R.C. § 178 (1987) (amortization of cost of acquiring a lease); I.R.C. § 180 (1987) (expenditures by farmers for fertilizers, etc.); I.R.C. § 184 (1987) (amortization of certain railroad rolling stock); I.R.C. § 195 (1987) (start-up expenditures); I.R.C. § 196 (1987) (deduction for certain unused business credits); I.R.C. § 212 (1987) (expenses for production of income); I.R.C. §§ 243-250 (1987) (special corporate deductions).

45. *E.g.*, I.R.C. § 163 (1987) (interest on indebtedness); I.R.C. § 166 (1987) (bad debts).

46. *E.g.*, I.R.C. § 169 (1987) (amortization of pollution control facilities); I.R.C. § 175 (1987) (soil and water conservation expenditures); I.R.C. § 194 (1987) (amortization of reforestation expenditures).

chase of private, state, and local bonds;⁴⁷ and various miscellaneous purposes.⁴⁸

The Joint Tax Committee estimated that tax expenditures totalled \$295 billion in 1983 and were projected to be \$421 billion in 1988.⁴⁹ Econometric studies generally indicate that tax incentives encourage spending patterns deemed by Congress to be socially valuable.⁵⁰ For example, the tax deduction encourages charitable giving at all income levels, although the response in the lower income classes is uncertain.⁵¹ The preferential capital gains tax rate⁵² was justified on the grounds that an otherwise higher tax rate would reduce the mobility of capital because investors would "lock-in" their investments over a long period of time since all gain is "bunched," that is, recognized in the year of sale.⁵³ Tax preferences for home ownership siphoned off some savings that otherwise might have been invested in plant and equipment, particularly in the 1970s when housing prices rose much faster than the general price level.⁵⁴ Tax incentives have also been effective in stimulating investments in historic preservation. Foregone federal tax revenues were small in comparison to the dollars invested to restore historic buildings.⁵⁵ Tax deductions and cost-sharing have promoted soil conservation measures by farmers whose land was eroding,⁵⁶ and favorable taxation of farm capital has tended to contribute to greater farm output.⁵⁷ Tax code provisions also alter corporate decision-making. For example, corporations will undertake new investments if the investments promise to yield a satisfactory rate of return after tax.⁵⁸

47. *E.g.*, I.R.C. § 171 (1987) (amortizable bond premium); I.R.C. §§ 141-150 (1987) (regarding state and local bonds).

48. *E.g.*, I.R.C. § 104 (1987) (excluding from income compensation for injuries or sickness); I.R.C. § 165 (1987) (losses not compensated by insurance); I.R.C. § 183 (1987) (activities not engaged in for profit); I.R.C. § 186 (1987) (excluding from income recoveries of damages for antitrust violations, etc.); I.R.C. § 213 (1987) (medical, dental, etc., expenses); I.R.C. § 219 (1987) (retirement savings); I.R.C. §§ 151-152 (1987) (certain personal exemptions).

49. A. ANDO, M. BLUME, & I. FRIEND, *THE STRUCTURE AND REFORM OF THE U.S. TAX SYSTEM 2* (1985). The 1988 figure assumed no changes in the 1983 tax law.

50. J. PECHMAN, *supra* note 33, at 92.

51. *Id.*

52. The Tax Reform Act of 1986 phased out the capital gains rate but simultaneously lowered the maximum rate for all income.

53. J. PECHMAN, *supra* note 33, at 111.

54. *Id.* at 146.

55. INFORMATION ON HISTORIC PRESERVATION TAX INCENTIVES, GAO/GGD-86-112FS (Aug. 1, 1986).

56. HOW TAX INCENTIVES ENCOURAGE SOIL AND WATER CONSERVATION INVESTMENTS, GAO/GGD-86-116FS (Aug. 13, 1986).

57. ECONOMIC EFFECTS OF SELECTED CURRENT TAX PROVISIONS ON AGRICULTURE, GAO/GGD-86-126BR (Aug. 11, 1986).

58. J. PECHMAN, *supra* note 33, at 142.

C. Specific Effects of Tax Subsidization on the Use of the Legal System

The legal system is unique in that it is both a "public good"⁵⁹ and a "private good."⁶⁰ As a public good, the legal system supplies general legal rules for the benefit of all its citizens.⁶¹ As a private good, albeit heavily subsidized through taxation, it supplies legal decisions in particular cases for the benefit of the specific parties involved. An "externality"⁶² exists in the private good aspect of the legal system because the cost of the "product" is not fully borne by those using it,⁶³ but is largely borne by society.⁶⁴ Externalities are significant in "the manner in which their existence distorts money prices so that they fail to indicate the true cost of production or the true benefits."⁶⁵ Since court filing fees and other court costs are relatively nominal compared to the value of the total services provided, the true cost of these services⁶⁶ is reflected as having a "cheaper" price than the services' actual cost.⁶⁷ Thus, this externality likely has a significant pro-litigation impact on potential litigants' choice of the legal system over ADR methods.⁶⁸

Our governmental system bears this cost, however, because "it is judged infeasible or inexpedient to sell [public goods]."⁶⁹ Government looks beyond the monetary costs of providing a service to nonmonetary considerations and goals.⁷⁰ Specifically, it can be argued that taxpayers' support of the legal system is economically justified because its function

59. "[A] person's consumption of a pure public good does not diminish any other person's consumption. In addition, once the good is produced, no one can be excluded from its use." A. SCHOTTER, *supra* note 22, at 58. Typical examples are police or fire protection or national defense, which are available to all residents.

60. "A private good has the property that one person's consumption of it totally precludes anyone else from consuming it." A. SCHOTTER, *supra* note 22, at 57.

61. L. FULLER, THE MORALITY OF THE LAW 145-51 (1969), *quoted in* D. LLOYD & M. FREEMAN, LLOYD'S INTRODUCTION TO JURISPRUDENCE 192 (5th ed. 1985).

62. A. SCHOTTER, *supra* note 22, at 28.

63. As examples, the cost of filing a complaint in the Franklin County, Ohio, Municipal Court is \$37.00, plus various minor fees for service of process, etc. The filing fee in the Fairfield County, Ohio, Court of Common Pleas is \$60.00, which includes service of process. Ordinarily, filing subsequent pleadings does not involve a fee.

64. For example, litigants are not billed for the time spent by judges and courthouse personnel in adjudicating their case.

65. J. OLIVER, *supra* note 29, at 33 (1979).

66. Court costs are independent of the potential litigant's counsel fees and costs. At the consultation stage or even at the filing stage, counsel fees and costs would probably be roughly comparable for ADR or litigation, regardless of which method the client, at that moment, was considering.

67. See *supra* notes 63-64.

68. "The effect is embodied in the *law of demand*: More is demanded of a thing when its relative price falls." D. MCCLOSKEY, *supra* note 12, at 19.

69. R. POSNER, *supra* note 31, at 363.

70. E. GRAMLICH, BENEFIT-COST ANALYSIS OF GOVERNMENT PROGRAMS 4 (1981).

is not solely dispute resolution, but also to establish rules⁷¹ designed to guide future conduct⁷² of other individuals in society. Consequently, if litigants had to bear the total cost of litigation, there might not be enough socially valuable litigation.⁷³

D. Specific Effects of Tax Provisions on the Use of ADR Methods

The extent and frequency of citizens' use of public resources depends largely upon the "eligibility" or "access" requirements imposed upon potential users of those resources. Thus, Nicholas Mercuro and Timothy Ryan stated:

[L]egal institutions will define and assign status rights which establish eligibility requirements for individuals to gain access to [public] goods and resources. This situation may be referred to as "government regulation" in its broadest sense. Thus legal institutions...affect the final public allocation and distribution of resources in society.⁷⁴

The Internal Revenue Code "defines and assigns status rights" with respect to tax expenditures which affect the choice of traditional litigious methods of dispute resolution versus the choice of "non-traditional" ADR methods.

This Note next considers the effect of four Internal Revenue Code sections on the choice of litigation versus ADR methods. Sections 104(a), 162(a), 212, and 262 of the 1987 Internal Revenue Code are examined because of their direct applicability⁷⁵ to the question of whether the tax system provides incentives to use litigation or provides disincentives to use ADR methods in the business and personal contexts.

1. *Business Expenses Under I.R.C. § 162(a) and § 212.* Under I.R.C. § 162(a), all "ordinary and necessary" business expenses may be deducted.⁷⁶ The deduction applies to "expenditures directly connected with

71. An interesting aside is a discussion by Cooter and Kornhauser on the evolving efficiency of legal rules. As summarized by Schotter, "The evolution in the common law will not establish the legal rule that is most efficient or wealth maximizing but that over time a variety of legal rules, some more efficient than others, will come to be used. Inefficient rules will never be weeded out of the legal system." A. SCHOTTER, *supra* note 22, at 30, citing Cooter & Kornhauser, *Can Litigation Improve the Law Without the Help of Judges?* 9 J. LEGAL STUD. 139 (1980).

72. D. LLOYD & M. FREEMAN, *LLOYD'S INTRODUCTION TO JURISPRUDENCE* 192 (5th ed. 1985).

73. R. POSNER, *supra* note 31, at 401. See also A. SCHOTTER, *supra* note 22, at 86.

74. N. MERCURO & T. RYAN, *supra* note 25, at 30.

75. I.R.C. § 186 (1987), regarding exclusion from income of recoveries of damages for antitrust and other violations, is not given consideration in this Note. However, because the purpose of I.R.C. § 186 (1987), is analogous to I.R.C. § 104(a) (1987), I.R.C. § 186 (1987) could be given treatment similar to the proposals made herein for I.R.C. § 104(a) (1987).

76. I.R.C. § 162(a) (1987) provides in part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...."

or pertaining to the taxpayer's trade or business"⁷⁷ and may include "a reasonable allowance for salaries or other compensation for personal services actually rendered."⁷⁸ In general, legal expenses are ordinarily deductible if paid or incurred as a result of some business transaction or primarily to preserve existing business, reputation, or good will.⁷⁹ Legal expenses include counsel fees⁸⁰ plus fees or expenses of accountants, witnesses, or other persons involved in the preparation and presentation of the taxpayer's case.⁸¹ It is unnecessary that litigation be involved,⁸² and the success or failure of the taxpayer in winning the contention usually does not affect deductibility.⁸³

Only one reported case specifically considered the issue of deductibility of expenses for arbitration as an alternative dispute resolution method. In *Jay A. Mount v. Commissioner*,⁸⁴ the Tax Court determined that the taxpayer's payment of \$185 to an attorney and an arbitrator to settle a dispute connected with the dissolution of two corporations in which he had interests was deductible as expenditures which proximately resulted from business. Mount, his wife, and two other people had formed two corporations involved in serving as manufacturers' agents. At the time the corporations were dissolved, Mount received nothing except one account and one month's salary of \$275 from one of the corporations. Believing that he and his wife were entitled to more, Mount

77. Treas. Reg. § 1.162-1(a) (1987).

78. Treas. Reg. § 1.162-7 (1987).

79. Certain expenses are not currently deductible expenses, however, and must be capitalized as capital expenditures. See I.R.C. § 263(a) (1987) and regulations thereunder. Some expenditures that must be capitalized are legal expenses involved in the acquisition of property having a useful life beyond the taxable year, *Woodward v. Commissioner*, 397 U.S. 572 (1970); bankruptcy proceedings, *Ringmaster, Inc. v. Commissioner*, 21 T.C.M. (CCH) 1024 (1962); condemnation proceedings, *Isaac G. Johnson & Co. v. United States*, 149 F.2d 851 (2d Cir. 1945); reorganization of the capital structure of a corporation, Rev. Rul. 67-125, 1967-1 C.B. 31; for trademark protection, *Rust-Oleum Corp. v. United States*, 280 F. Supp. 296 (N.D. Ill. 1967); acquiring a capital asset, *John C. Smith II*, 36 T.C.M. (CCH) 932 (1977) and *Lester Kisska*, 42 T.C.M. (CCH) 1651 (1981); for removing cloud from title to mineral rights, *Burton-Sutton Oil Co. v. Commissioner*, 150 F.2d 621 (5th Cir. 1945), *cert. denied*, 326 U.S. 755 (1945), *rev'd*, 328 U.S. 25 (1946).

80. See *Tennessee Valley Leather Co. v. Commissioner*, 8 T.C.M. (CCH) 396 (1949); *Cornelius Vanderbilt, Jr.*, 16 T.C.M. (CCH) 1081 (1957); *George S. Viereck v. Commissioner*, 4 T.C.M. (CCH) 1026 (1945); *San Marco Shop, Inc. v. Commissioner*, 12 T.C.M. (CCH) 843 (1953).

81. See *Meyer & Bro. Co.*, 4 B.T.A. 481 (1920); *Mattie W. Budreau v. United States*, 52 Am. F. Tax Rep. 1274 (CCH) (1957).

82. E.g., *Superheater Co.*, 12 B.T.A. 5 (1920); *O'Day Investment Co.*, 13 B.T.A. 1230 (1928); *Florists' Transworld Delivery Ass'n v. Commissioner*, 67 T.C. 333 (1976); *Henry M. Rodney*, 53 T.C. 287 (1969); *Langford Investment Co.*, 28 B.T.A. 222 (1933).

83. See, e.g., *Glynn W. Keeling*, 30 T.C.M. (CCH) 954 (1971); *Longhorn Portland Cement Co.*, 3 T.C. 310 (1944), *rev'd* 148 F.2d 276 (1945), *cert. denied*, 326 U.S. 728 (1945).

84. 5 T.C.M. (CCH) 1004 (1946).

engaged the services of an attorney for \$500 and an arbitrator for \$375.⁸⁵ The tax court's opinion stated that:

[W]e see no difference in principle between the situation here and the partnership account involved in *Kornhauser v. U.S.*, 276 U.S. 145, in which attorney's fees were held a deductible business expense. The expenditures here involved were "directly connected with" or "proximately resulted from" the business, within the meaning of the *Kornhauser* case, and are, we think, a proper deduction⁸⁶

Thus, the tax code, as interpreted by the Tax Court, makes no preference between business expenditures for litigation and ADR methods since both are equally deductible from gross income.

I.R.C. § 212⁸⁷ operates similarly to § 262, except that § 212 is concerned with the activities of individuals in non-business but profit-oriented activities.⁸⁸ To qualify for a deduction under § 212, the taxpayer "must satisfy the same requirements that apply to a trade or business expense under § 162 except that the person claiming the deduction need not be in a trade or business."⁸⁹ The mechanics of § 212 operate somewhat differently from § 162 in that § 212 deductions are generally itemized deductions while § 162 deductions are excluded from the computation of gross income.⁹⁰

2. *Personal Legal Expenditures Under I.R.C. § 262.* Under I.R.C. § 262,⁹¹ legal expenditures incurred for personal benefit, such as divorce, criminal defense, and personal injury suits, are non-deductible personal expenses.⁹² One exception to this rule is that legal fees incurred in obtaining alimony payments pursuant to a divorce or separation proceeding are "ordinary and necessary expenses...for production or collection of income" and, therefore, are deductible by the payor of such legal fees under I.R.C. § 215 provided the alimony is includable in the recipient's gross income under I.R.C. § 71.⁹³ Consequently, under the

85. *Id.* at 1007.

86. *Id.* at 1008.

87. I.R.C. § 212 (1987) provides in part that: "[I]n the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—(1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income...."

88. S. GUERIN & P. POSTLEWAITE, *PROBLEMS AND MATERIALS IN FEDERAL INCOME TAXATION* 699 (1986).

89. *Snyder v. United States*, 674 F.2d 1359, 1364 (10th Cir. 1982) (quoting *Fischer v. United States*, 490 F.2d 218, 222 (7th Cir. 1973)).

90. S. GUERIN & P. POSTLEWAITE, *supra* note 88, at 699.

91. I.R.C. § 262 (1987) provides that: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

92. Examples of non-deductible personal legal expenditures include fees paid to settle a suit for wrongful expenditure of funds, *Sheldon Solomon v. Commissioner*, 33 T.C.M. (CCH) 588 (1974), and recover damages to personal auto seized by a foreign country, *Gurry v. Commissioner*, 27 B.T.A. 1237 (1933).

93. Treas. Reg. § 1.262-1(b)(7) (1987).

tax code, neither litigation nor ADR is given preference since neither is deductible from gross income.

3. *Damages and Awards Under I.R.C. § 104(a)*. Under I.R.C. § 104(a),⁹⁴ compensatory damages for tortious personal injuries⁹⁵ are excludable⁹⁶ from income.⁹⁷ According to the Internal Revenue Service, punitive damages are includable in gross income whether the award is for personal injuries⁹⁸ or for injury to the taxpayer's business and professional reputation.⁹⁹ To be excludable, the amounts must be received "through prosecution of a legal suit or action based upon tort or tort-type rights, or through a settlement agreement entered into in lieu of such prosecution."¹⁰⁰ The settlement may be made in a lump sum or in periodic payments.¹⁰¹ Again, neither litigation nor ADR methods enjoy a tax advantage since compensatory awards from both methods are excludable from gross income.

94. I.R.C. § 104(a) (1987) provides, in pertinent part, that: "[G]ross income does not include—(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness; (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness...."

95. For an excellent discussion of the confusion in the courts as to what damages for personal injuries are excludable, see Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries*, 23 HOUS. L. REV. 701 (1986).

96. "Exclusions" are "accessions to wealth" which permanently bypass taxation by specific statutory provision due to some policy consideration. S. GUERIN & P. POSTLEWAITE, *supra* note 88, at 115. Exclusions like the exemption of personal injury compensation from taxation are not "tax expenditures" since the policy rationale for the provision is, assuredly, not the promotion of personal injuries. However, certain exclusions, in some circumstances, arguably may have the effect of promoting certain activities just as tax expenditures do. The exclusion for interest derived from state and municipal bonds, for instance, undoubtedly lowers their cost to investors and, therefore, makes such bonds more attractive investments.

97. I.R.C. § 104(a) prevents a "double deduction" by disallowing a deduction for that portion of the compensatory award which is for medical and other expenses which were deducted in a prior taxable year pursuant to I.R.C. § 213 (1987): "Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year...." I.R.C. § 104 (1987).

98. Rev. Rul. 84-108, 1984-2 C.B. 32.

99. Rev. Rul. 85-143, 1985-37 I.R.B. 7. The Ninth Circuit, however, has taken the contrary view: "This injury to the person should not be confused with the derivative consequences of the defamatory attack, *i.e.*, the loss of reputation in the community and any resulting loss of income. The nonpersonal consequences of a personal injury, such as a loss of future income, are often the most persuasive means of proving the extent of the injury that was suffered." *Roemer v. Commissioner*, 716 F.2d 693, 699 (9th Cir. 1983).

100. Treas. Reg. § 1.04-1(c) (1987). The regulation does not extend this requirement to workmen's compensation payments.

101. Rev. Rul. 77-230, 1977-2 C.B. 214; Rev. Rul. 79-220, 1979-2 C.B. 74; Rev. Rul. 79-313, 1979-2 C.B. 75.

III. SPECIFIC PROPOSALS

A. *Proposed Changes to the Internal Revenue Code*

Herein are proposed changes to federal income tax sections which affect the decision to litigate or not litigate. Current text is in Roman characters and proposed changes are in italics.

§ 162. *Trade or business expenses*

(a) In general. — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including —

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered, *except:*

(A) *Costs of alternative dispute resolution methods shall be deductible for one hundred twenty percent of cost if such alternative dispute resolution method resolves a dispute prior to commencement of a civil action under rule 3 of the Federal Rules of Civil Procedure or under a similar state rule;*

(B) *Costs of prosecuting a civil action shall be deductible —*

(i) *in full if settled by the parties after commencement of a civil action under rule 3 of the Federal Rules of Civil Procedure or under a similar state rule, but prior to commencement of discovery by the taxpayer under rules 26 through 37 of the Federal Rules of Civil Procedure or similar state rules;*

(ii) *for eighty percent of cost if settled by the parties after the taxpayer has commenced discovery under rules 26 through 37 of the Federal Rules of Civil Procedure or similar state rules but before commencement of trial under rules 38 through 53 of the Federal Rules of Civil Procedure or under similar state rules.*

(iii) *for sixty percent of cost if settled by the parties after trial has commenced under rules 38 through 53 of the Federal Rules of Civil Procedure or under similar state rules but before the jury or court has returned its verdict.*

(iv) *for forty percent of cost if the civil action is concluded by a verdict or if the taxpayer appeals the verdict.*

[The remainder of §162 has been omitted.]

§ 212. *Expenses for production of income*

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income;

(3) in connection with the determination, collection, or refund of any tax;

(4) *except that, with respect to the cost of resolving a dispute, costs of alternative dispute resolution methods shall be deductible for one hundred twenty percent of cost if such alternative dispute resolution method resolves a dispute prior to commencement of a civil action under rule 3 of the Federal Rules of Civil Procedure or under a similar state rule;*

(5) *except that, with respect to the cost of prosecuting a civil action related to the income-producing activity—*

(a) *the costs shall be deductible in full if settled by the parties after commencement of a civil action under rule 3 of the Federal Rules of Civil Procedure or under a similar state rule, but prior to commencement of discovery by the taxpayer under rules 26 through 37 of the Federal Rules of Civil Procedure or similar state rules;*

(b) *the costs shall be deductible for eighty percent of cost if settled by the parties after the taxpayer has commenced discovery under rules 26 through 37 of the Federal Rules of Civil Procedure or similar state rules but before commencement of trial under rules 38 through 53 of the Federal Rules of Civil Procedure or under similar state rules;*

(c) *the costs shall be deductible for sixty percent of cost if settled by the parties after trial has commenced under rules 38 through 53 of the Federal Rules of Civil Procedure or under similar state rules but before the jury or court has returned its verdict.*

(d) *the costs shall be deductible for forty percent of cost if the civil action is concluded by a verdict or if the taxpayer appeals the verdict.*

§ 262. *Personal, living, and family expenses*

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

No deduction shall be allowed for costs incurred in the prosecution or defense of any civil action; however, there shall be allowed as a deduction fifty percent of the costs of prosecuting or defending a dispute resolved under alternative dispute resolution methods. This deduction shall not apply to costs incurred in prosecuting or defending a criminal case.

§ 104. *Compensation for injuries or sickness*

(a) *In general.* — Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

(2) *the amount of any damages received—*

(a) *by suit, whether as lump sums or as periodic payments, on account of personal injuries or sickness;¹⁰²*

(b) *by agreement, whether as lump sums or as periodic payments, on account of personal injuries or sickness,¹⁰³ and the taxpayer may*

also deduct from gross income an amount equal to twenty percent of the amount of the damages received therefrom.

B. Explanation of Proposal

1. § 162 and § 212. A graduated scale of deductibility is proposed for business expenditures incurred in prosecution of a civil suit, with the percentage dependent upon the stage at which the suit is settled. Under proposed § 162(a)(1)(A) and (B) and proposed § 214(4) and (5), a schedule of deductibility is based on when a civil action is settled. In brief form, the schedule is as follows:

<i>Percentage</i>	<i>Point at Which the Suit is Settled</i>
120%	For use of ADR methods in any dispute for which a civil action is never filed
100%	Settlement between filing of civil action and commencement of discovery
80%	Settlement after commencement of discovery and before commencement of trial
60%	Settlement after commencement of trial but before jury or court has returned its verdict
40%	If suit is concluded by verdict or is appealed

The percentages listed are completely arbitrary; they could easily be adjusted. The idea is to establish quantifiable thresholds at which a particular strategy decision has a dollar cost both directly, "How much will it cost to continue?," and indirectly, "Of the total cost, how much will not be deductible?" In theory, this would tend to encourage settlement of cases when a low marginal additional benefit would discourage a party from proceeding to the next stage of litigation. This assumes, however, that people can accurately and rationally weigh the effect of current out-of-pocket costs versus the future net tax benefit which is always less than the out-of-pocket costs.¹⁰⁴ In addition, from an accounting standpoint, the gain in revenues from the damages recovered may be significantly reduced by the expenses, such as legal expenses and income taxes incurred in, or as a result of, obtaining damages.¹⁰⁵

The operation of the proposal may be explained as follows: Assume that a dispute involves a breach of contract where the maximum damages

102. This language is changed from present I.R.C. § 104 (1987) in that the substantive law relating to compensation "by suit" is made a separate section from that relating to compensation "by agreement." The substantive provision is, however, the same as current law.

103. The non-italicized text is changed from present I.R.C. § 104 (1987) in that the substantive law relating to compensation "by agreement" is made a separate section from that relating to compensation "by suit." The non-italicized substantive provision is, however, the same as current law.

104. See text and tables which follow.

105. See text and tables which follow.

will be \$10,000. Since recoveries for non-tortious injuries are includable in gross income, the additional benefit to be derived (i.e., a larger damages award) from one stage of litigation to the next must at least equal the loss to be incurred from the decreased deductibility of the litigation's costs and the increased out-of-pocket expenses. The examples of mathematical calculations which follow—from the plaintiff's perspective—are based upon the following assumptions:¹⁰⁶

Stage 1 — § 162(a)(1)(A) or § 212(4):

If negotiating costs prior to filing of the civil action are \$1,000.00, then \$1,200.00 is deductible as 120 percent of the cost incurred.

Stage 2 — § 162(a)(1)(B)(i) or § 212(5)(a):

Assume that the costs of negotiating, between the time of filing the civil action and commencement of discovery, added another \$1,000.00 in costs, for a total of \$2,000.00.

Stage 3 — § 162(a)(1)(B)(ii) or § 212(5)(b):

Assume that costs between the commencement of discovery and commencement of trial added another \$1,000.00 in costs, for a total of \$3,000.00.

Stage 4 — § 162(a)(1)(B)(iii) or § 212(5)(c):

Assume that costs between the commencement of trial and return of the court's or jury's verdict added another \$1,000.00 in costs, for a total of \$4,000.00.

Stage 5 — § 162(a)(1)(B)(iv) or § 212(5)(d):

Assume that another \$1,000.00 in costs is added due to appeal of the verdict, for a total of \$5,000.00.

From these assumptions, the following calculations illustrate the effect of the proposed changes to Sections 162 and 212:

Stages	Gain In Taxable Income ¹⁰⁷	Amount of Deduction	Net Taxable Gross In- come ¹⁰⁸	Net Tax Increase ¹⁰⁹	Lost Out-Of- Pocket Expenses ¹¹⁰	Net Gain ¹¹¹
One	\$10,000	\$1,200	\$8,800	\$3,388	\$1,000	\$5,612
Two	\$10,000	\$2,000	\$8,000	\$3,080	\$2,000	\$4,920
Three	\$10,000	\$2,400	\$7,600	\$2,926	\$3,000	\$4,074
Four	\$10,000	\$2,400	\$7,600	\$2,926	\$4,000	\$3,074
Five	\$10,000	\$2,000	\$8,000	\$3,080	\$5,000	\$1,920

106. The assumptions made are purely arbitrary.

107. This figure represents the damages recovered.

108. This figure represents the gain in taxable income (the damages recovered) minus the amount of the deduction.

109. This assumes that the net taxable income is taxed at the rate of 38.5 percent, which is the maximum tax rate for individuals for tax years beginning 1987. I.R.C. § 1 (1987).

110. This figure represents the cost of litigation.

111. This figure represents the gain in taxable income minus the net tax increase minus the lost out-of-pocket expenses.

Thus, from an accounting standpoint,¹¹² the plaintiff that accurately estimates the net benefit to be derived from pursuing litigation from one stage to the next would be wise to settle before the civil action is filed. This conclusion is also true under present tax law; however, current law preserves more of the net, after-tax gain from litigation in the taxpayer's pocket. The outcomes under present law is illustrated below:

Stages	Gain In Taxable Income	Amount of Deduction	Net Taxable Gross Income	Net Tax Increase	Lost Out-Of Pocket Expenses	Net Gain
One	\$10,000	\$1,000	\$9,000	\$3,465	\$1,000	\$5,535
Two	\$10,000	\$2,000	\$8,000	\$3,080	\$2,000	\$4,920
Three	\$10,000	\$3,000	\$7,000	\$2,695	\$3,000	\$4,305
Four	\$10,000	\$4,000	\$6,000	\$2,310	\$4,000	\$3,690
Five	\$10,000	\$5,000	\$5,000	\$1,925	\$5,000	\$3,075

Now, assume that the plaintiff estimated that the potential damages to be recovered could be more than \$10,000. The plaintiff's decision to advance from one stage of litigation to the next should be dependent upon whether the *additional* gain in net after-tax income would result in a gain greater or equal to the gain to be derived if the civil action were settled prior to filing suit.¹¹³ The following table illustrates the increase in potential recoverable damages necessary to achieve such a result:

Stages	Gain In Taxable Income	Amount of Deduction	Net Taxable Gross Income	Net Tax Increase	Lost Out-Of Pocket Expenses	Net Gain
One	\$10,000	\$1,200	\$ 8,800	\$3,388	\$1,000	\$5,612
Two	\$11,125	\$2,000	\$ 9,125	\$3,513	\$2,000	\$5,612
Three	\$12,750	\$2,400	\$10,100	\$3,888	\$3,000	\$5,612
Four	\$14,126	\$2,400	\$11,726	\$4,514	\$4,000	\$5,612
Five	\$16,003 ¹¹⁴	\$2,000	\$14,003	\$5,391	\$5,000	\$5,612

Thus, in order for the plaintiff-taxpayer to deem it valuable to advance from one stage of litigation to the next, the potential recoverable damages, labeled net gain in taxable income, would have to increase sufficiently to allow at least the \$5,612 recoverable by settlement before commencement of litigation.

112. By this I mean that the benefit or efficiency of additional litigation—the income to be derived—is judged on a cost basis, that is, how much does it cost to obtain the income received. What would the balance sheet look like? In Stage One, for instance, the income (settlement of \$10,000) is partly offset by expenses of \$1,000 (counsel fee) and \$3,388 (net increase in income tax), for a total net benefit of that \$10,000 award being only \$5,612.

113. This assumes that the defendant would be willing to settle for the minimum damages amount of \$10,000.

114. Unless the court of appeals orders modification of the trial award to this amount,

The intent of the "by the taxpayer" language in the proposal is to temper the effect of diminished deductibility on parties who do not initiate the suit. For example, a party would not face coercion to settle by a threat to "commence discovery," because the threatened party would not slip to the 80% deductibility level until commencing his own discovery. This threshold concept would also be the same for each party in the multi-party context.

Several problems develop, however, for which Treasury regulations would be needed to provide clarification. "Alternative dispute resolution methods" would need to be defined, at least in general terms. ADR would need to be defined so as to exclude legal fees not incurred in relation to a pending dispute. Also, since litigation ordinarily lasts more than one year, especially where appeals are involved, how the proposed statute should be applied since, as written, it does not supply methodology for deductibility under those circumstances, must be considered.

2. *§ 262 Personal, living, and family expenses.* The proposed additions to this section would continue to deny deductibility of costs incurred in court system litigation, as does the present law. This preserves the status quo policy that personal expenses are non-deductible unless given special statutory treatment.¹¹⁵ The section would be changed, however, to permit deduction of fifty percent of the costs incurred in resolving a dispute under alternative dispute resolution methods. Again, the proposed percentage is completely arbitrary. The idea is to establish a quantifiable threshold at which a particular strategy decision has a dollar cost both directly (How much will it cost to sue?) and indirectly (If I resolved the dispute by a method other than lawsuit, how much could I deduct? How much would this decrease my ultimate tax liability?).

This proposed section is not written with the same complexity of the business deduction sections in order to preserve, albeit in a small way, some simplicity in the tax code as it relates to individual taxpayers. This approach, however, results in some inequity as the commencement and completion of a civil action is necessary, in certain situations, to determine the legal rights or status of the parties. For example, a divorce may be obtained only through a civil action. Consequently, for taxpayers whose legal rights must necessarily be determined through the court system, the deduction would be unavailable.

3. *§ 104(a). Compensation for injuries or sickness.* The proposed amendment to Section 104(a) is, unlike the rest of the provision, a tax expenditure. The proposal operates simply. For example, assume that

the appeal would result in a decrease in net income below the \$5,612 figure. If the defendant appealed, then the plaintiff would be wise to attempt to settle for an amount between \$14,376 and \$16,003, under these facts.

115. S. GUERIN & P. POSTLEWAITE, *supra* note 88, at 441.

the attorney for the injured person obtains from the potential defendant's insurance company an acceptable settlement offer of \$5,000. Under current law, if the injured person accepts that offer, he would exclude the \$5,000.00 from his gross income. Under the proposal, he would exclude the \$5,000.00 from his gross taxable income *and* deduct an additional 20 percent of that amount (\$1,000.00) from his gross income. Under these facts, that deduction would result in a net tax savings of from \$110.00 to \$385.00, depending on the taxpayer's tax bracket.¹¹⁶ This savings would, in effect, increase the size of the settlement award 2.2 percent for taxpayers in the lowest tax bracket and 7.7 percent for taxpayers in the highest tax bracket.

IV. CRITICISMS OF THE TAX PREFERENCE APPROACH

A. *Can the Tax Preference Approach Work?*

Some may argue that the tax preference approach is unlikely to directly result in increased use of ADR methods. It may be that widespread use of court-centered litigation¹¹⁷ is based upon legal practitioners' familiarity with it and the novelty of new organized ADR methods:

With "innovative but not well-known procedures...[parties] are unlikely to give them a try unless they are officially recognized and sanctioned.... By their very nature, most new and somewhat unorthodox alternatives will be appropriate only in select circumstances; however, in these circumstances, they may represent the best solution. Also, as time passes, such alternatives may gain wider acceptance and be considered appropriate in a greater number of cases."¹¹⁸

In addition, other unresolved questions remain, such as the legal enforceability of decisions or agreements reached by ADR methods.¹¹⁹

B. *Questions Left Unanswered*

Before adopting a policy, a decision-maker wants to know the benefits and costs of the proposed policy. The method of evaluation, from a strictly economic standpoint, is "[i]n any choice situation, select the

116. For tax years beginning in 1987, individual tax rates range from 11 percent to 38.5 percent. I.R.C. § 1 (1987).

117. The term "court-centered litigation" is used as a reminder that ADR forms such as arbitration are often merely trials outside of the courthouse.

118. Freedman, *supra* note 10, at second page prior to i.

119. This subject is discussed in Burns, *The Enforceability of Mediated Agreements: An Essay on Legitimation and Process Integrity*, 2 OHIO ST. J. DIS. RES. 93 (1986) and in Bernstein, *The Desirability of a Statute for the Enforcement of Mediated Agreements*, 2 OHIO ST. J. DIS. RES. 117 (1986).

(policy) alternative that produces the greatest net benefit."¹²⁰ From this seemingly straightforward prescription arises a host of complex evaluations to confront the economic analyst and policymaker regarding the proposals contained herein:

1. How much loss in revenue to the federal government will occur from the tax incentives/disincentives?
2. How much will these provisions save in dollars for (1) the federal court system and (2) state court systems?
3. How much will these provisions reduce the backlog in (1) the federal court system and (2) state court systems? Will the savings restrain the need for additional judges?
4. How much will potential or actual litigants save in (1) dollars, (2) time and inconvenience, or (3) other values?
5. As a type of indirect intergovernmental grant program,¹²¹ does the revenue loss accurately reflect the gains federal and state courts receive from decreased usage of court time and resources?
6. Do the ADR methods provide the (1) same or better quality, or (2) consistency of decisions as litigation?
7. Should we encourage people to not use the court system?

This Note represents merely the beginning of a discussion of the economic, tax, and policy implications of adopting such a proposal. Nevertheless, a tentative conclusion may be reached.

V. CONCLUSION

Some may argue that tax expenditures are inappropriate because such preferences or "loopholes" are contrary to the goals of reform and simplification of the tax system. Some scholars, such as Wharton School economists Ando, Blume, and Friend conclude that "[t]axes undoubtedly provide some disincentives to the economic activity being taxed, but there is no strong evidence that these disincentives in the aggregate are very substantial."¹²² Policymakers must believe it is true, however, because even after passage of the Tax Reform Act of 1986, many deductions, credits, and exclusions still exist.¹²³

120. E. GRAMLICH, *supra* note 70, at 43, (quoting E. STOKEY & R. ZECKHAUSER, A PRIMER FOR POLICY ANALYSIS 137 (1978)).

121. Intergovernmental grant programs generally transfer federal revenues to state or local governments (or state transfers to local governments) for the purpose of carrying out a general or specific program in lieu of the grantor government doing it. Tax provisions, such as those proposed in Part III, could be considered an indirect grant because of their presumed incentive effect to reduce private individuals' usage of state resources in the form of court time and resources.

122. A. ANDO, M. BLUME, & I. FRIEND, *supra* note 49, at 6.

123. See *supra* notes 39-48.

because even after passage of the Tax Reform Act of 1986, many deductions, credits, and exclusions still exist.¹²³

Litigation is the nobleman to which all attorneys must acknowledge. In Joseph Raz's words,

Lawyers' activities are dominated by litigation in court, actual or potential. They not only conduct litigation in the courts. They draft documents, conclude legal transactions, advise clients, etc., always with an eye to the likely outcome of possible litigation in which the validity of the document or transaction or the legality of the client's action may be called into question.¹²⁴

Litigation, whether potential or actual, has a pervasive influence upon the legal community and its clients. If we accept the crisis-characterization made by former United States Deputy Attorney General Laurence H. Silberman, that "[t]he legal process, because of its unbridled growth, has become a cancer which threatens the vitality of our forms of capitalism and democracy[.]"¹²⁵ then we should adopt one or more cures for that crisis.

We have a choice, as James M. Buchanan persuasively stated: "Men must look at *all* institutions as potentially improvable. Man must adopt the attitude that he can control his fate; he must accept the necessity of choosing. He must look on himself as a man, not another animal, and upon 'civilization' as if it is of his own making."¹²⁶

Therefore, we are left with the problem of choosing appropriate institutional arrangements for shaping the character of our economic and legal life.¹²⁷ Tax law changes may be the least obtrusive means to effect a change in marketplace decision-making which now overwhelmingly chooses litigation.

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123. See *supra* notes 39-48.

124. Raz, *The Problem About the Nature of Law*, 3 CONTEMPORARY PHILOSOPHY, (quoted in D. LLOYD & M. FREEMAN, LLOYD'S INTRODUCTION TO JURISPRUDENCE 477 (5th ed. 1985)).

125. Silberman, *Will Lawyering Strangle Democratic Capitalism?* REG., Mar./Apr. 1978, at 15.

126. Buchanan, *Law and the Invisible Hand*, THE INTERACTION OF ECONOMICS AND THE LAW 127 (B. Siegan ed. 1977).

127. N. MERCURO & I. RYAN, *supra* note 25, at 37.

